The Conference Board

Volume 2, Number 2 February 1991

Economic Times

INSIDE:

- **What to Do About the Recession - Colloquium** *(page 3)*
- **How Should the Soviets Deal With Their Economic Crisis?** *(pages 4-5)*
- **Brazil, Too** *(page 5)*
- **Al Sommers on the U.S. Automobile Market** *(page 7)*
- **Stat File and Crystal Ball** *(pages 8-11)*

Editor's Note

Economic policy advice is the main theme of this issue, starting on the next page with the views of our Colloquium on U.S. policies for dealing with the recession. Next you will find a compelling set of recommendations from a blue- ribbon panel of economists on how the U.S.S.R. should cope with its critical economic situation, which seems to grow more menacing every day, followed by a look at the impact of the policy regime put in place by Brazil's President Collor. The parallels between the U.S.S.R. and Brazil are especially interesting.

On other issues, our long-time colleague, Al Sommers, focuses his always perceptive eye at the automobile market from a not-so-usual angle. And then we tossed in a little piece called "Life Among the Econ," just for the pure fun of it.

Ed Fiedler

Pun of the Month:

How do you spot an old forecaster? Easy, they're long of sooth!

Rising Profits in Recession?

Those worrying that the 1990-91 recession will be long and deep focus heavily on the wide international scope of the current cyclical weakness and the likelihood that credit availability will be restricted because of the strained capital position of so many banks. On the other side, there are many analysts — a majority, by all reports — who expect a short, mild recession because the low dollar creates a highly advantageous competitive position for U.S. producers in world markets, and because the usual cyclical excesses and maladjustments that help bring on a recession — such excesses as a big inventory overhang — are absent.

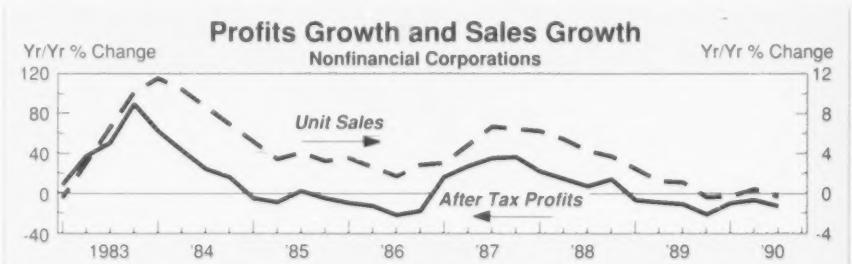
Another of the "usual suspects" conspicuous by its absence in the present situation is a difficult environment for profits. In most cycles, when the economy approaches a recession, costs begin to rise faster than prices and productive efficiency begins to deteriorate, both of which squeeze profits, which in turn feeds the recession by discouraging hiring plans and inducing cutbacks in capital expenditures.

In 1990, however, although productivity growth was held down by the slow growth in output, costs were otherwise kept under close control, so that — depending on which series you look at — profitability either improved slightly or softened slightly over the first three quarters of the year.

These auspicious indications about 1990 profits are being reaffirmed currently by the favorable expectations for 1991 so widely held by security analysts. The company-by-company forecasts of one well regarded Wall Street house show profits rising over 1990 in 42 of the 48 industries covered. Yes, that's right, the firm says we're in a recession, and yet the analysts are looking for profits to advance in an overwhelming majority of industries.

You're skeptical? You have every reason to be! In fact, don't believe it for a minute! Profits always drop during a recession, along with sales and all the other broad indicators of economic activity, both in the aggregate and across a majority of industries, usually a large majority. The chart below demonstrates the close relationship between profits growth and sales growth. The reasons are that when the economy declines, productivity also deteriorates, and price inflation slows faster than cost inflation. So profits drop sharply, and that will hold true in this recession, too.

Nevertheless, the optimism about 1991 profits that exists in Wall Street — and I believe also in the corporate boardrooms of America — is a strong signal that the economy entered this cyclical downturn without serious price-cost distortions and thus that profitability may well prove to be a less troublesome component of the current recession than is usually the case.



Copyright 1991 by The Conference Board.
Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and November/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to Economic Times, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

The Conference Board, 845 Third Avenue, New York, New York, 10022
The Conference Board Europe, Avenue Louise, 207 - Bte 5, B-1050 Brussels, Belgium
The Conference Board of Canada, 255 Smyth Road, Ottawa, Ontario, K1H-8M7

Colloquium

Background:

Today's policymakers are operating in formidable times. By itself, the recession would be more than challenge enough. But in addition, the already dismal budget outlook is deteriorating rather than — as advertised after the painful fiasco last fall — improving. The Federal Reserve faces serious credit stresses throughout the financial system. And both must take account of the international turbulence in the Middle East, the U.S.S.R., GATT, and elsewhere.

Question:

In your view, are the authorities pursuing appropriate monetary and fiscal policies? What changes, if any, do you recommend?

Don R. Conlan
Capital Strategy Research

Fiscal policy is rudderless so *che sera, sera*, depending on defense needs. Monetary policy is quite deflationary when adjusted for shifts in liquidity preference and credit turbulence. Renewed attention to the growth in monetary aggregates should have come earlier and probably would have without the jump in oil prices. But, hey, who am I to second-guess the Federal Reserve in this sea of uncertainty? It's the only functional economic policy weapon we have, but a patriot missile it ain't. War of any kind, including against inflation, is accident prone; so let's support the troops — there and here.

Laura D'Andrea Tyson
University of California, Berkeley

Recession, not inflation, is now the major enemy. Expansionary fiscal and monetary policies are proven weapons. The fiscal weapon is operating automatically as a result of countercyclical stabilizers. A war tax or any other deficit-cutting measure would offset these stabilizers, causing a self-inflicted wound. The monetary weapon is not automatic — it requires concerted action by the Fed to lower interest rates still further and to ease the credit crunch. Like the Allied command in the Gulf, economic policymakers must correctly identify the enemy and take coordinated action to defeat it.

Lyle E. Gramley
Mortgage Bankers Association

Sharp changes in macroeconomic policies are not the medicine needed to bring the economy out of recession. Thankfully, both the Administration and the Fed know that. The Fed has paved the way for a turnaround with gradual easing measures and encouragement to banks to lend more freely. Early termination of the Gulf war will bolster consumer confidence and keep oil prices down. The news on that front is promising; let's hope it stays that way.

Isabel V. Sawhill
The Urban Institute

I recommend a steady-as-we-go fiscal policy. Record-setting deficits of over $300 billion are inevitable this year given the weak economy, the S&L crisis, the war, and the removal of Social Security from the figures. But over the longer run deficits are headed down and Congress should resist the temptation to undo that progress by suspending the new budget rules in response to a flagging economy. A far better course, should the recession linger, is to ease monetary policy.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

The Soviet Economic Crisis: Steps to Avert Collapse

The Soviet economy faces a worsening economic crisis that makes it essential immediately to:

1. Liberalize prices
2. Corporatize enterprise
3. Stabilize government spending and restrict credit
4. Moderate the social costs of unemployment, and
5. Open the economy to competition, both internally and internationally.

Liberalize prices. At present, prices remain controlled for more than 80 percent of total retail sales. To "liberalize" these prices means ending controls, allowing sellers to set prices that will cover their costs, without state subsidies. This will mean that goods will be available in the shops, which is not true currently.

The freeing of all retail and wholesale prices will lead to immediate price increases for most goods. Consumers will therefore face a reduction in their real wages, but they will also benefit from reduced time spent in lines, as the current system of rationing-by-queues requires. The ruble will buy less, but it will buy something. The price increases will bring goods from the back of the shop, where they are now sold illegally for high prices to a select few, to the front, available to all willing to pay the market-determined prices.

Price liberalization sets the stage for greater economic efficiency, by giving enterprises the incentive to serve the consumer. Competition will begin to develop, leading to improved efficiency, the only basis for improving the standard of living of the Soviet people.

Corporatize State Enterprises. Large enterprises must be converted into independent, self-financing, and profit-maximizing organizations. They must no longer be under the direction of the Ministries or dependent on the government budget for subsidies and investment funds. This step is distinct from privatization, which will require more time.

Directors of an enterprise must have the authority to set prices, output, and wages, as well as to determine inputs and financing. They must be free to enter whatever markets they wish to enter — except for such natural monopolies as the railroads and distribution of electricity, water and gas.

Self-financing or financial autonomy — a condition required to impose hard budget constraints on all large enterprises — means they can obtain money from only three sources: sales of their products, borrowing from banks, or sale of their assets. The enterprise must know that unprofitability ultimately means bankruptcy for the firm and economic ruin for the managers. The possibility of bankruptcy is the stick that makes enterprises efficient. The carrot is that successful enterprises retain a portion of their profits for bonuses to managers and to expand and improve their facilities.

In contrast to large state enterprises, retailing, services, and small-scale manufacturing can be privatized quickly by sale or leasing. All regulatory constraints on new entry into such markets should be abolished, except the minimum necessary to protect public health and safety (e.g., sanitary standards for restaurants and food stores).

Government Spending and Credit. The worsening inflation and hoarding must be restrained by reducing the budget deficit, tightening credit and liberalizing prices. In the budget we recommend focusing on spending reductions rather than tax increases, most importantly by removing subsidies to state enterprises. Automatic indexation for price increases should be minimized; perhaps the only exception would be for transfer payments to low-income households.

The Gosbank should extend credit only to firms that can repay it, and must place overall credit limits on the enterprise sector, much as western central banks do today. Real interest rates must be positive. The only certain way to check inflation is the threat of unemployment and bankruptcy that prevents firms from raising prices; for this, tight government budgets and credit policies are essential.

Opening the economy internationally will provide consumer goods, speed the introduction of foreign technology, ensure that prices reflect competitive world market prices, and restrain monopolistic forces inside the Soviet Union.

Dealing with Unemployment. The steps recommended here will inevitably mean unemployment for large numbers of workers. Economic progress is impossible if every worker is guaranteed his or her job in its present location. Unemployment compensation is the only way to prevent severe hardship for workers in the transition. The level of compensation, however, must be substantially below the wages of those who continue to work and should decrease with the length of unemployment, in order to preserve incentives for workers to relocate, retrain and accept alternative employment.

Open the Economy Internationally. In addition to creating an open, competitive market economy **within** the Soviet

Union, as the recommendations we have made to this point would do, opening the economy internationally can play a critical role. We recommend moving to a convertible currency and removing import and export restrictions very quickly. Opening the economy will provide consumer goods, speed the introduction of foreign technology, ensure that prices reflect competitive world market prices, and restrain monopolistic forces inside the Soviet Union.

Conclusion. We recognize that these proposals will be painful and controversial. They impose major social costs in the short run as the Soviet society makes the transition from a centralized administrative approach to the decentralized direction of individuals through markets. Moreover, it is not possible to provide an ironclad guarantee that these measures will cure the nation's ailments. But history shows again and again that allowing markets to direct an economy offers the best hope for resuscitating the sick economy and for raising living standards toward those in Western Europe and the United States.

Excerpted from a memorandum prepared at the request of Stanislav S. Shatalin, a leading economic adviser in the U.S.S.R. and main author of the 500-day plan to move the Soviet economy quickly toward a market system — the plan rejected by the Soviet Parliament. The November 1990 memorandum — thus far not published in the U.S.S.R. — was the product of a distinguished panel chaired by Merton J. Peck (Yale), and including Wil Albeda (MERIT, Netherlands), Barry Bosworth (Brookings), Richard Cooper (Harvard), Alfred Kahn (Cornell), William Nordhaus (Yale), Thomas Richardson (Yale) and Kimio Uno (Keio University, Japan). ■

The Brazilian Economy — The Recession is Not the Worst

by Geraldo Hess

The most serious aspect of the present economic crisis in Brazil is that business executives are losing sight of what is behind President Collor's plan. Those who think the recession is the major problem start from the premise that the principal objective of the Collor Plan is to destroy inflation, and that once the inflationary battle is won the Brazilian economy is going to continue as before.

Nothing could be more wrong. The principal goal of the plan is to provoke a real opening of the country to external competition. If that goal is achieved and inflation is overcome, Brazil is going to be very different than it was.

Previously, Brazil was a place where markets were reserved for companies doing business here. Brazilian companies only had to compete internally; the true competitors, external products, were out of play. As a result, Brazilian executives were preoccupied with making the product. Little attention was given to quality and service. And they could achieve high profit margins.

Now, if the economy is really opened, executives will have to adopt a broader, longer term vision. Product quality will become more important. Service will have to be part of the business. Profit margins will be much thinner. And it will no longer be possible to produce only what the company knows, but rather what the customers want. Consequently, despite all the difficulties, Brazilian companies will have to become truly efficient in order to compete.

Otherwise, all that will remain is to pray that the external attack will be delayed, and to continue business as usual while failing. After all, even death is only a question of time.

(Note: As of early January, the issues discussed here have become partly outdated. Inflation is again — at least for now — the major concern, and prospects for success of the full plan are highly questionable.)

Geraldo Hess is a Brazilian business consultant, and member of the Board of Directors of fourteen business groups. An earlier version of this commentary was published in the magazine, Amana.

Quotable Quote

The "Money Belt" Recession *by Edward J. Campbell*

The current recession did not start in the "farm belt," the "rust belt" or the "energy belt." This is a "money belt" recession, where both individuals and institutions have taken in their belts a notch. Individuals have tightened their spending belts because of reduced real incomes and uncertainties about the Middle East. And the banks have tightened their lending belts because of tougher standards imposed upon them by the regulators. These two constraints, together, were the progenitors of the 1990-91 recession.

Edward J. Campbell is Chief Economist, Brown Brothers Harriman & Co.

Life Among the Econ

by Dr. Axel Leijonhufvud, University of California at Los Angeles

The Econ tribe occupies a vast territory in the far North, bleak and dismal. Traveling through it makes for rough sledding. The Econ are not without some genuine attachment to their ancestral grounds, however, and their young are brought up to feel contempt for the softer living in the warmer lands of their neighbors, the Polscis and the Sociogs.

For such a primitive people, the social structure is quite complex. An extremely interesting aspect of status among the Econ is that status relationships do not seem to form a simple hierarchical "pecking-order," as one is used to expect. Thus, for example, one may find that A pecks B, B pecks C, and then C pecks A! This non-transitivity of status may account for the continual strife among the Econ, who are known widely as the "quarrelsome race." Social cohesion is apparently maintained chiefly through shared distrust of outsiders.

The dominant feature among the Econ is the way that status is tied to the manufacture of certain types of implements, called "modls." The facts (a) that the Econ are highly status-motivated, (b) that status is only to be achieved by making "modls," and (c) that most of these "modls" seem to be of little or no practical use, probably accounts for the backwardness and abject cultural poverty of the tribe.

The rise of certain groups within the tribe seems to be associated with the trend among all the Econ towards more ornate, ceremonial modls, while the low rank of others is due to the fact that, in recent times, they have not strictly enforced the taboos against association with the Polscis and Sociogs. The elite Econ look upon this with considerable apprehension as endangering the moral fiber of the tribe.

The Econ and the Future. The prospect for the Econ is bleak. They are poor — except for a tiny minority, miserably poor. In their poverty, they are not even saved from the problems of richer nations — travellers tell of villages half-buried in the refuse of unchecked modl-making. Even their famous Well Springs of Inspiration are now polluted.

Econ political organization is weakening. The power of the elders has been eroding for some time. Respect for one's elders is no more the fashion among the young Econ than among young people anywhere else. Recognized status has come increasingly to be tied to cleverness in modl-making.

Under circumstances such as these, we expect alienation, disorientation, and a general loss of spiritual values. And this is what we find. A typical phenomenon indicative of the break-up of a culture is the loss of a sense of history and growing disrespect for tradition. Contrary to the normal case in primitive societies, the Econ priesthood does not maintain and teach the history of the tribe. In some Econ villages, one can still find the occasional elder who takes care of the modls made by some long-gone hero of the tribe and is eager to tell the legends associated with each. But few of the adults or grads, noting what they regard as the crude workmanship of these dusty old relics, care to listen to such rambling fairytales. Among the younger generations, it is now rare to find an individual with any conception of the history of the Econ. Having lost their past, the Econ are without confidence in the present and without purpose and direction for the future.

Excerpted from Axel Leijonhufvud, *Information and Coordination*, Oxford University Press, 1981, New York and Oxford.

Albert T. Sommers' Statistical Insight

Automobiles-Growth With Vigorous Maybe Violent Competition

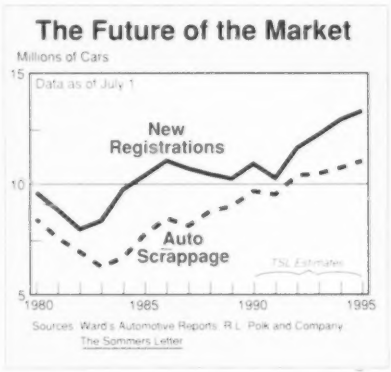
Albert T. Sommers
Senior Fellow and
Economic Counsellor
The Conference Board

The automobile holds a distinctive place in the American economy and its culture, and in the dreams and aspirations of Americans. A nearly unique American combination of upward social mobility, large distances, cheap gasoline and mechanical inventiveness long ago identified the automobile with American society far more intimately than elsewhere. As a result, for large parts of the 20th Century the U.S. economy went the way of the automobile market; in the later 1920's, in fact, an officially recognized "recession" was produced by a several months model change-over at Ford.

All of the postwar recessions were characterized by a depressed auto market. Now comes 1991, and recession has already made its mark in sharp curtailment of auto production schedules. Where is this major industry headed?

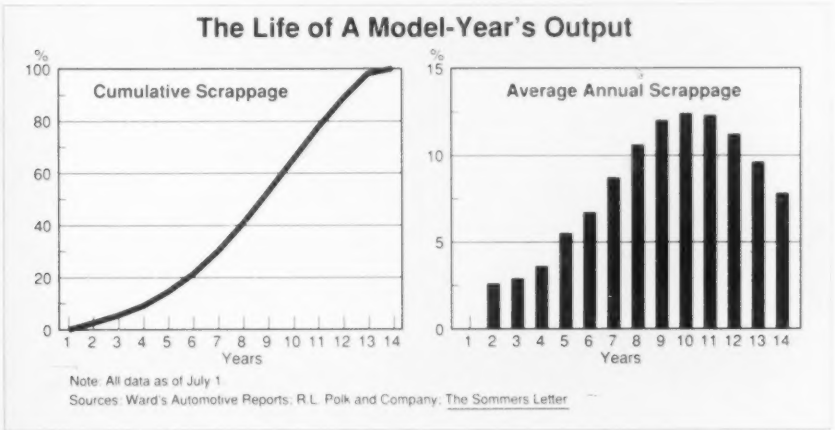
From the point of view of the aggregate system, a number of variables come into play that regulate the course of auto sales. Of these, the scrappage rate of automobiles is probably the most important. The figures on scrappage are a little esoteric, and not frequently reported; they are nevertheless very useful in getting a loose fix on the future of the market, because the scrappage cycle for an automotive model year is surprisingly constant across model years. It is therefore feasible to construct an average or theoretical scrappage cycle; and because the scrappage rate is very low in the early life of a model, aggregate scrappage turns out to be reasonably predictable for several years beyond the end of the actual data on scrappage. *At least the replacement market for automobiles in the near future can be known.*

The chart below shows the accumulation of the scrappage against a year's automotive production; by thirteen years out practically all the production is off the road. The right-hand panel shows the percentage of the output scrapped each year, indicating a peak scrappage rate of 12 or 13 percent of the production around the tenth and eleventh year. Finally, the second chart shows the actual scrappage over the past decade, and projected scrappage to 1995; the estimates rest a little on assumed production to 1995, but the probable error is small, since scrappage in the early years of the model is low. Shown with the scrappage line are the actual annual registrations of new automobiles; the projections to 1995 rest partly on expected household formation, and intuition about the short-term economic outlook. The gap between the two lines is, of course, the net change in the stock of automobiles on the road. On average something like 85 percent of automobile production is simply to replace scrapped vehicles, and only 15 percent for growth of the market itself.



The implications of these figures are that the U.S. automobile market still has a lot of room to grow after recession is over; the growth rate will depend upon the growth of incomes, consumer confidence, prices, and the increase in the number of U.S. households.

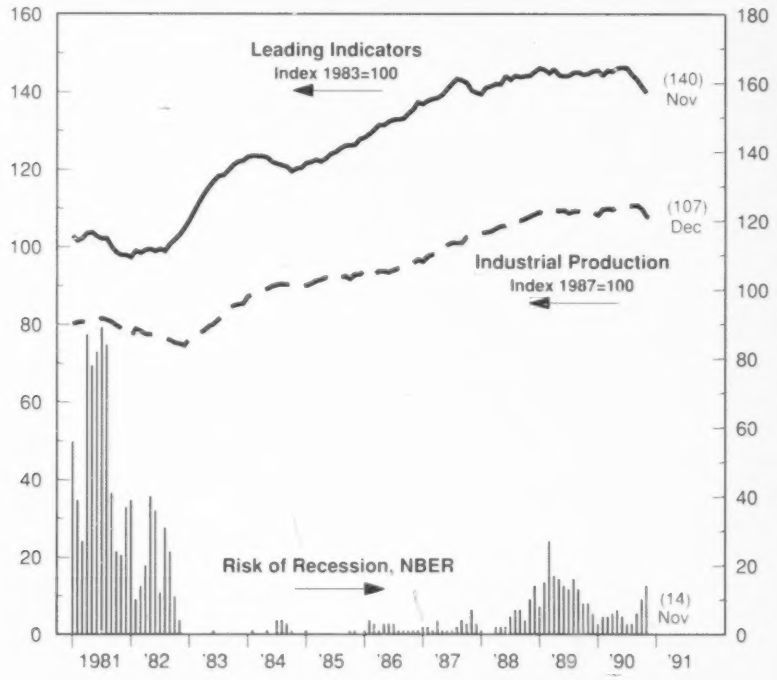
While the market will gradually get bigger in the future, its growth rate does not look dramatic, particularly in the light of the growth rate of output of the so called "transplants" — foreign automobile companies producing in the United States. For the early 1990's, what all of these abstruse calculations suggest is that the automobile industry in the United States has opportunities for moderate growth over the next half-dozen years, as ownership and scrappage rise, but that the market will be vigorously, maybe even violently, competitive.



Conference Board Stat File

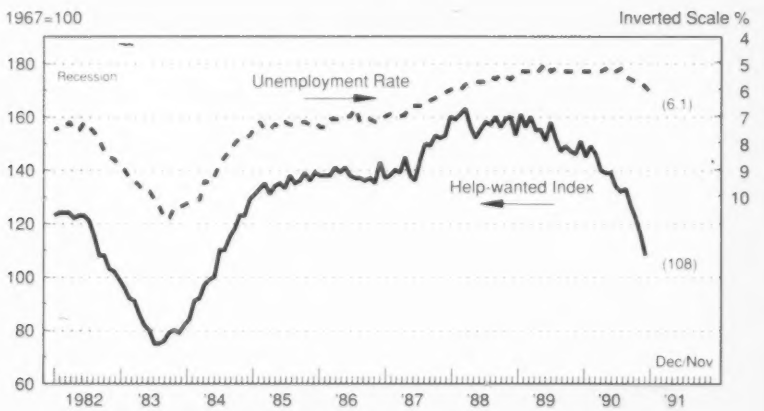
Data in the Stat File this month fully reaffirm that the economy is in the recession stage of the business cycle. The question turns, then, to the possibility of an early recovery. For now, the only indicator pointing in that direction — not to be dismissed but less than persuasive by itself — is the 3 month upswing in stock prices. Otherwise the present cycle looks very typical of the post-World War II experience, with no significant sign of either a shorter and milder recession or one longer and steeper than the normal range. *(Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339 0331.)*

Confidence



Leaders and production show typical recession dive; NBER calculation shows a curiously modest "risk"!

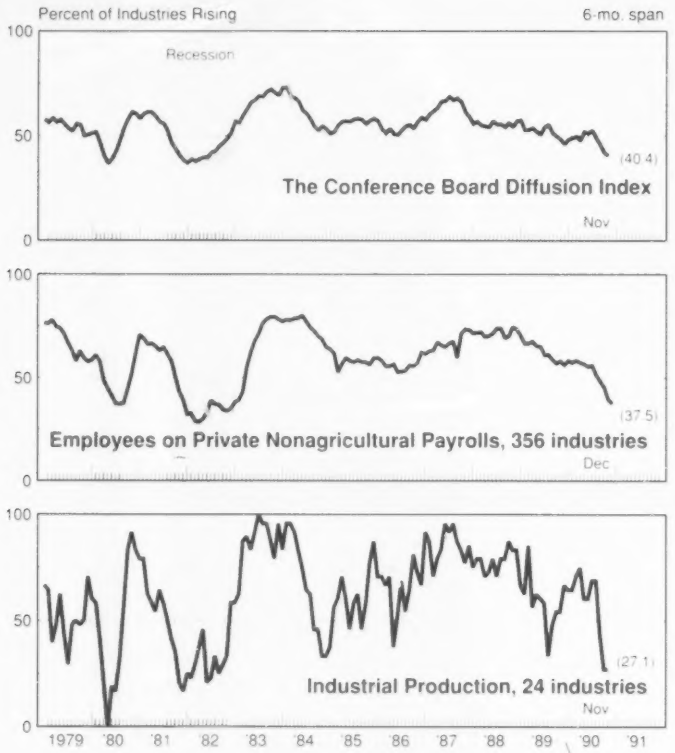
Help-wanted Advertising and Unemployment



Labor markets continue to show weakness.

Conference Board Stat File

Indexes of Economic Momentum



Downturn widespread, typical of recession.

Core inflation steady in recent months; recession impact, if any, still to be seen.

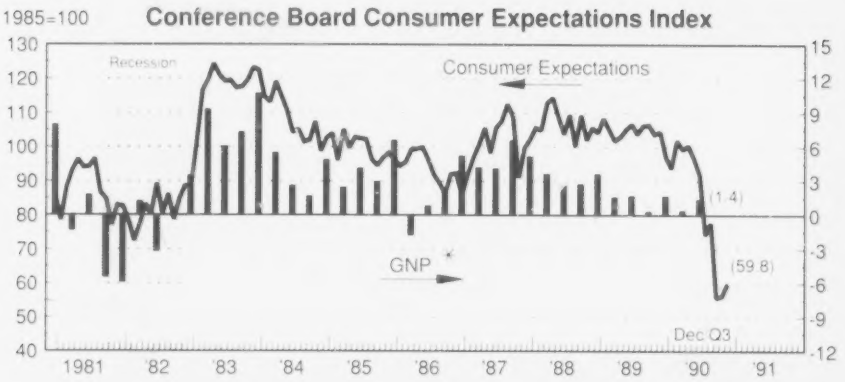
Inflation Fundamentals

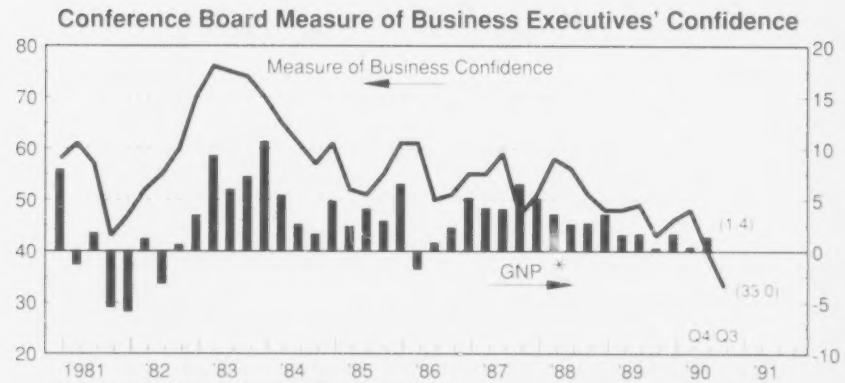
* Core Inflation = CPI excluding food at home and energy.

* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e., excluding the benefits that are part of the ECI)

Conference Board Stat File

Confidence

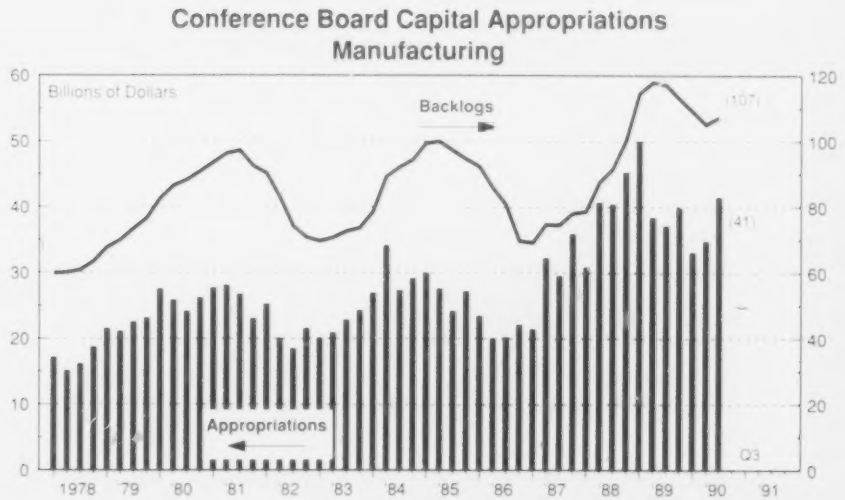




* Quarterly percent changes in GNP at annual rates

Confidence remains very low.

Investment Intentions



Third-quarter appropriations surprisingly robust.

Inside the Crystal Ball

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Date of Forecast		Jan.	Jan.	Jan.	Jan.	Jan.	Jan.	Jan.	Jan.		
Gross National Product											
(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)											
		%	%	%	%	%	%	%	%		
Actual	1990 2Q	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	2Q 1990	Actual
	3Q	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	3Q	
Forecast	4Q	-2.1	-3.5	-2.1	-3.9	-1.9	-3.3	-3.0	-2.3	4Q	Forecast
	1991 1Q	-2.9	-1.6	-1.8	-2.8	0.7	-2.1	-2.1	-0.9	1Q 1991	
	2Q	-2.1	-2.5	-1.2	-0.2	1.5	-1.1	-0.4	2.3	2Q	
	3Q	0.8	0.4	2.0	1.1	1.1	2.4	3.0	4.1	3Q	
	4Q	5.3	3.1	2.7	1.2	1.7	2.9	3.6	3.3	4Q	
	1992 1Q	7.8	3.0	3.5	0.8	2.3	3.2	4.6	2.6	1Q 1992	
	2Q	4.7		4.5	3.0	1.8	3.8	4.3	2.3	2Q	
	3Q	3.9		4.5	2.5	2.2	3.2	3.1	2.7	3Q	
	4Q	2.9		4.5	2.8	2.4	2.9	3.0	6	4Q	
Inflation (GNP Deflator)											
(Percent change from same quarter one year earlier)											
	1990 4Q	4.5	4.5	4.7	4.6	4.7	4.6	4.1	4.3	1990 4Q	
	1991 4Q	3.7	4.1	4.6	3.3	4.6	3.1	3.1	2.9	1991 4Q	
	1992 4Q	2.6		4.0	4.3	4.6	2.2	2.9	3.3	1992 4Q	
Unemployment Rate											
(Percent, quarterly)											
Actual	1990 2Q	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	2Q 1990	Actual
	3Q	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	3Q	
Forecast	4Q	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	4Q	Forecast
	1991 1Q	6.7	6.5	6.4	6.2	6.3	6.3	6.6	6.4	1Q 1991	
	2Q	7.2	7.0	6.8	6.6	6.5	6.8	7.1	6.5	2Q	
	3Q	7.4	7.1	6.9	6.6	6.6	7.0	7.1	6.5	3Q	
	4Q	7.1	6.9	6.8	6.8	6.6	7.0	7.1	6.4	4Q	
	1992 1Q	6.5	6.6	6.7	6.9	6.5	7.0	6.8	6.4	1Q 1992	
	2Q	6.2		6.5	6.7	6.4	6.8	6.6	6.3	2Q	
	3Q	5.9		6.3	6.4	6.4	6.6	6.4	6.3	3Q	
	4Q	5.8		6.1	6.0	6.4	6.4	6.2	6.2	4Q	

The Conference Board
845 Third Avenue
New York, N.Y. 10022

Second Class
Postage paid at New York, NY
and at
additional mailing offices

Statistical Reference Index
Acquisitions
4520 East West Highway
Suite 800
Bethesda, MD 20814